Supreme Court, U.S.
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No.

In The
Supreme Court of the United States
OCTOBER TERM, 1999

O.S.C. & ASSOCIATES, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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January 27, 2000

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QUESTION PRESENTED

In determining whether a corporation's claimed deduction for employee-shareholders's compensation payments is proper, may the United States Tax Court and the Ninth Circuit adopt a new all-or-nothing rule of law (which is not clearly articulated) upon which the deduction can be denied in full based solely upon a factual finding that the payments were without compensatory intent?, or must they instead follow 26 CFR § 1.162-7, determine and allow as deductions those amounts of compensation that are reasonable and are paid for services rendered, and disallow only the excess, if any, of the amounts claimed as deductible compensation payments?

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

The Petitioner in this case is O.S.C. & Associates, Inc., a California corporation.

The Petitioner is a closely-held, privately-owned corporation. There is no parent corporation or publicly-held corporation that owns 10% or more of the corporation's stock.

The Respondent in this case is the Commissioner of Internal Revenue.

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PETITION FOR A WRIT OF CERTIORARI
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Petitioner O.S.C. & Associates, Inc., a California corporation, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The order of the Court of Appeals denying the rehearing is unreported, but it is attached at App. at A-40 The decision of the Court of Appeals on the merits (App. at A-10) is reported at 187 F.3d 1116. The decision of the United States Tax Court on the merits (App.at A-1) is reported at T.C. Memo. 1997-300.

JURISDICTION

The order of the Court of Appeals denying the rehearing was entered on November 2, 1999. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1),

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 162(a)(1) of Title 26 of the United States Code permits a corporation to deduct "a reasonable allowance for salaries or other compensation for services personally rendered."

Section 1.162-7(a) of 26 CFR (hereinafter "Treasury Regulation") provides that:

> "There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."

Copies of Treasury Regulations §§1.162-7(b) and -8 are attached at App. A-41 & A-43

STATEMENT OF THE CASE

In 1970, Allen Blazick bought a silk-screening business for $180.00. As the business grew, Blazick hired his brother-in-law, Steven Richter, to assist with manufacturing. In 1976 their enthusiasm, energy and hard work started to pay off when Blazick landed Safeway Stores as a client. It is undisputed that Blazick and Richter continued to bring their extraordinary talent, dedication, and energy to the business, and that the business prospered remarkably as a direct result of their personal efforts. (App.at A-2, A-15)

In 1982, the business was incorporated under the name "O.S.C. & Associates, Inc." ("OSC"). Three years later, it adopted an incentive compensation plan. The incentive compensation plan was developed by Leo Rosi, a college acquaintance and OSC's long-time certified public accountant. Blazick and Richter were the plan's only participants. Under the terms of the plan, the amount of incentive compensation was to be determined at the end of each fiscal year by first calculating a hypothetical gross margin. This was done by multiplying OSC's actual total sales by an adjusted industry gross margin ratio. The total incentive compensation pool consisted of the difference between OSC's actual gross margin and the hypothetical adjusted industry gross margin. (App.at A-2, A-3, A-15, A-16.)

Blazick owned 90% of the stock of OSC and Richter owned 10%. The plan expressly provided that payments from the incentive compensation pool would be made according to stock ownership. It directed that after specific deductions were taken from each participant's share, 90% of the total compensation pool would be allocated to Blazick,

and the remaining 10% would be allocated to Richter. Each year, Blazick's incentive compensation was to be reduced by any inventory shortages in excess of $100,000 and by any bad debts. Richter's incentive compensation was to be reduced by inventory spoilage in excess of $100,000 and production costs in excess of $100,000. As a practical matter, this formulation resulted in the corporation distributing nearly all (between 82% and 94%) of its net income as incentive payouts to Blazick and Richter, in addition to their base salaries, for its fiscal years ended October 31, 1990; October 31, 1991; and October 31,1992. (App.at A-3 to A-5, A-15 to A-18.) OSC deducted all of the base salaries and incentive compensation paid out to Blazick and Richter during those years as compensation under 26 U.S.C. §162(a)(1). The IRS disallowed most, but not all, of OSC's claimed deductions of incentive compensation to Blazick and Richter. The amounts claimed as deductions, and the amounts allowed and disallowed by the IRS are as follows:

Compensation	1990	1991	1992
Blazick			
Base Salary	$155,372	$ 175,485	$ 173,372
Incentive Comp.	490,860	1,651,146	1,324,608
Richter			
Base Salary	57,791	64,616	60,000
Incentive Comp.	98,036	83,461	149,179
Total Compensation Deducted by OSC	$802,058	$2,075,068	$1,707,159
Allowed by IRS	444,606	494,437	508,482
Disallowed by IRS	$357,453	$1,580,631	$1,198,677

(App.at A-17.)

At trial before the Tax Court, OSC offered considerable evidence of Blazick and Richter's extraordinary hard work and unique skills, and of its phenomenal growth and better-than-average performance due to their personal efforts. (App.at A-18.) The Commissioner conceded at trial that Richter's compensation was reasonable, but presented persuasive expert testimony that Blazick's compensation was not reasonable to the extent that it exceeded $472,000, 918,000 and $788,000, respectively, for the fiscal years ended October 31, 1990, 1991 and 1992. This concession would have allowed OSC to deduct $1,343,918 more than allowed in the notice of deficiency. (App.at A-38.)

The Tax Court agreed with the Treasury Regulations that for such compensation payments to be deductible, two elements must be present: (1) The amount must be reasonable, and (2) the expense must relate to compensation for services actually rendered. 26 CFR § 1.162-7(a). It relied upon *Elliotts, Inc. v. Commissioner,* 716 F.2d 1241, 1243 (9th Cir. 1983), *rev'g.* T.C. Memo 1980-282, which referred to these two elements as a "two-prong" test.

The Tax Court then either misunderstood or misapplied the second prong of the two-prong test of *Elliotts, Inc., supra.* The Ninth Circuit in *Elliotts, Inc., supra,* recognized that the second prong, which requires a "compensatory purpose, can be difficult to establish because of its subjective nature." The Tax Court, however, without discussion, expanded it into an all-or-nothing test of compensatory intent. It then found that there was no compensatory intent in OSC's payments of incentive compensation to them. (App.at A-8.) Consequently, without addressing the issue of whether all or even some of the compensation paid to Blazick and Richter was reasonable

and was for services rendered, it concluded that, because the payments were without compensatory intent, they did not constitute compensation for services, and it sustained the Commissioner's proposed adjustments. Id.

On appeal, the Court of Appeals also, without discussion, referred to the second prong of the test in *Elliotts, Inc., supra,* as a "compensatory intent" test. It held that OSC must separately satisfy both a reasonableness test and a compensatory intent test; that reasonableness alone will not suffice.. (App.at A-21) The Tax Court found that there was no compensatory intent, and it therefore sustained the Commissioner's proposed adjustments in their entirety. (App. at A-8.) Apparently, without considering that the new all-or-nothing compensatory test was a substantial change in the long-standing legal standard applied in reasonable compensation cases, the Ninth Circuit applied the clear error rule to review The Tax Court's factual finding that there was no compensatory intent in OSC's payments of incentive compensation to Blazick and Richter. The Court of Appeals held that the Tax Court's factual finding was not clearly erroneous, and it affirmed the Tax Court's determination. (App.at A-22.)

The Tax Court applied and the Court of Appeals approved a new all-or-nothing test to determine the reasonableness of the compensation paid by OSC to Blazick and Richter for services rendered. Neither Court, however, articulated what this new test was or <u>how</u> it was to be applied. Is a finding of no "compensatory intent" the result of a balancing of factors evidencing compensatory intent (i.e., claiming compensation deductions) against factors not evidencing such intent (i.e. making payments in proportion to shareholdings) ?

On September 30, 1999, OSC timely filed a Petition for Rehearing and Suggestion for Rehearing En Banc. On November 2, 1999, the Court of Appeals entered an order rejecting the Petition for Rehearing and Suggestion for Rehearing En Banc. (App.at A-40.)

REASONS FOR GRANTING THE WRIT

The issue of whether compensation paid to an employee-shareholder of a closely-held, privately owned corporation is deductible in full by the corporation is an extremely important and recurring one. It has spawned more tax litigation than almost any other tax issue. The Ninth Circuit's decision has interjected yet more uncertainty in this area by approving a new all-or-nothing "compensatory intent" test which is independent of the "reasonableness" test used by the courts for over a half a century. This new and independent, all-or-nothing "compensatory intent" test not only directly conflicts with decisions of the Fourth Circuit and the Fifth Circuit, but it also: (1) Creates uncertainty in compensation decisions of thousands, if not millions, of closely-held, privately owned corporations throughout the United States; and (2), misreads and misapplies the long-standing Treasury Regulations in this area.

The deductibility of compensation for closely-held, privately-owned corporations should be determined by a test of reasonableness measurable by amounts ordinarily paid for like services by like enterprises under like circumstances. 26 CFR §1.162-7(b)(3). That is what the Regulation requires. The Regulations do not use the word "intent." The only two elements to be used in the determination of whether compensation is deductible are whether the amount of the compensation is reasonable, and whether it is paid for

services rendered. 26 CFR § 1.162-7(a). Although the second element may be subjective in nature, requiring a determination of whether the payments are actually for services rendered, and not for property or as disguised dividends, it is not a "compensatory intent" test. Review by this Court is urgently needed to provide guidance to many thousands of closely-held, privately-owned corporations in determining levels of compensation that may be indispensable to the success of their businesses.

A. The Ninth Circuit's Rule Conflicts With The Rule Of Both The Fourth Circuit and the Fifth Circuit

Neither the Tax Court nor the Ninth Circuit attempted to apportion OSC's compensation payments into a portion which is deductible, notwithstanding that it may not have been solely for a compensatory purpose, and a portion which is not. Rather, the Tax Court created a new all-or-nothing "compensatory intent" test. Clearly, OSC must have had some compensatory intent as it deducted the payments to Blazick and Richter as compensation payments on its Federal income tax returns. However, apparently not realizing that it was approving a new and unarticulated standard, the Ninth Circuit approved the new test and applied the clear error test on review. It determined that the Tax Court's factual finding that there was no compensatory intent was not clearly erroneous. As the new test was an all-or-nothing test, any inquiry into the reasonableness of the amount of the compensation paid for services rendered was therefore precluded; such an inquiry became irrelevant. Consequently, the Ninth Circuit affirmed the decision of the Tax Court, resulting in a determination which sustained the Commissioner's proposed adjustments in full.

Such a result is as surprising as it is wrong. The

Commissioner himself, in proposing his adjustments, allowed a portion of the incentive compensation payments. The amounts allowed exceeded the combined base salaries in each of the three years as follows:

	1991	1992	1993
Allowed Total Compensation Deduction to Blazick and Richter	$444,606	$494,437	$508,482
Combined Base Salaries	213,163	239,101	233,372
Allowed Incentive Compensation (See p. 4, supra.)	$231,443	$255,336	$275,110

Such a result is even more surprising in view of the Commissioner's concession at trial that Richter's total compensation was reasonable, and that Blazick's incentive compensation was reasonable to the extent of $316,628 ($472,000 less base salary of $155,372), $732,515 ($918,000 less base salary of $175,485) and $614,628 ($788,000 less base salary of $173,372), respectively, for the years 1990, 1991 and 1992. (See App. at A-38) This concession would have allowed OSC to deduct $1,343,918 more than allowed in the notice of deficiency. (Id.)

In this case, the Tax Court and the Ninth Circuit have added and approved, respectively, a new and independent, all-or-nothing "compensatory intent" test. They have expanded the second part of the "two-prong" test of *Elliotts,*

Inc., supra, far beyond its role of determining whether the compensation payments are for services rendered. Consequently, a finding that the new "compensatory intent" test has not been satisfied makes an inquiry into the first prong of the Elliott's test - the "reasonableness" test - irrelevant, and it prevents any analysis of whether even some portion of the claimed compensation deduction is properly deductible.

That is simply not the law. Even if *some* purported compensation payments were made without the requisite compensatory purpose (*i.e.*, if they were not made for services rendered), the taxpayer *is still* entitled to a deduction equivalent to the reasonable amount of compensation paid to the shareholder-employees for services rendered. 26 CFR §1.162-7(b)(1). For example, under the regulations, if an employee-shareholder performed services and it were determined that the reasonable value of those services was $10,000, the corporation would be entitled to a $10,000 deduction even if it were subsequently determined that the $10,000 was paid without compensatory intent. Of course, there is always some evidence of compensatory intent if only because the payments must be deducted as compensation by the corporation before they can be disallowed on audit.

The second prong of the test of *Elliotts, Inc., supra,* was never meant to be an independent, all-or-nothing "compensatory intent" test. Rather, it was meant simply to determine whether purported compensation payments which were reasonable in amount were also for services rendered, and not for property or as a disguised dividend. 26 CFR §§1.162-7(a) and (b); *Elliotts, Inc., supra;* see *Commissioner v. R. J. Reynolds Tobacco Co.,* 260 F.2d 9 (4th Cir. 1958). It may be reasonable to pay a CEO-shareholder a certain level

of compensation; but, if he or she doesn't do anything, and if the CEO's functions are in fact performed by a son or daughter who is next in line for the job, there is no compensatory purpose. The deduction of the payments to the CEO-shareholder by the corporation would be properly disallowed. However, if the CEO did perform some of the services for which the payments were made, a portion of the payments would be properly deductible.

The Ninth Circuit in *Elliotts, Inc., supra,* reversed and remanded that case with instructions that the Tax Court, on remand, begin its analysis by looking at the reasonableness of the compensation formula which was used. By interpreting the second prong of the test of *Elliotts, Inc., supra,* as an independent, all-or-nothing "compensatory intent" test, the Ninth Circuit precludes an examination of the reasonableness of the compensation which OSC paid and which it deducted as compensation on its Federal income tax returns (which, at the very least, implies the existence of a compensatory intent). Such a rule directly conflicts with the rules established by both the Fourth Circuit and the Fifth Circuit, it is contrary to the governing regulations, and it establishes a new rule of law which is wrong and unworkable.

1. The Rule of the Fourth Circuit

The case of *R. J. Reynolds Tobacco Co., supra,* involved the interpretation and application of a statutory predecessor *identical* to Code §162(a)(1) and a regulatory provision *identical* to that of Treas. Reg. §1.162-7(a), the provisions applicable in this case. The facts involved a corporate taxpayer which, under a bylaw, provided for annual payments in the discretion of its board of directors to

its officers and employees, not to exceed a certain percentage of profits, and to be apportioned among them according to their holdings and shares of the corporation's stock. Because of the payments under the bylaw, the corporation paid relatively low fixed salaries. The Commissioner disallowed the deduction claimed for the payments under the bylaw. The Tax Court, however allowed a portion of the bylaw payments as corporate deductions.

On appeal, the Commissioner argued that a payment under the bylaw was not apportionable. He argued for an "all-of-nothing" test: If any portion was a nondeductible dividend, it was all a nondeductible dividend. *R. J. Reynolds Tobacco Co.*, 260 F.2d at 12. The Tax Court disagreed; it held that a portion of the bylaw payments was deductible as reasonable compensation for services. Dismissing the Commissioner's argument , the Fourth Circuit stated:

> "If there is a reasonable basis in the record for isolating that part of the payment which is reasonable compensation for services, we think that a deduction for that part should be allowed. This is true whether the excess is classified as unreasonable compensation or as dividends. There is no basis in reason, the Tax Code, or administrative practice for the insistence that the part which is not deductible fatally infects the part which clearly is." *Commissioner v. R. J. Reynolds Tobacco Co.*, 260 F.2d 9, 12 (4th Cir. 1958).

The Commissioner also argued that the Court failed to apply the proper legal test of compensation. He stressed the last phrase of the regulation which provides that the test of deductibility in the case of compensation payments is

whether they are reasonable and are in fact payments purely for services. The Commissioner argued that the last phrase meant that *no* part of the payments under the bylaw may be allowed as a deduction if the employee was required to do anything other than perform services, and that since the Corporation's bylaw required employees to acquire stock to be entitled to the payments under the bylaw, neither the payments as a whole, nor any part, could properly be viewed as "purely for services." That is, the Commissioner argued that the "purely for services" portion of the regulations constituted the same all-or-nothing test which was adopted by the Tax Court and the Ninth Circuit in this case.

The Fourth Circuit both addressed and rejected this argument:

> "The construction of the regulation which the Commissioner suggests is needlessly rigid and unnatural. We think the phrase "purely for services" simply means that no deduction shall be allowed for payments that are not for services but represent dividends or capital distribution. The requirement that the employees shall own a corporation's stock cannot ipso facto convert into dividends, payments which were purely for services. Those payments which were intended to and did in fact compensate for services actually rendered are deductible; the rest are not." *Id.* at 12-13.

Determining that the finding of the Tax Court that portions of the bylaw payments were deductible as reasonable compensation was not clearly erroneous, the Fourth Circuit affirmed its decision.

The rule of the Fourth Circuit is exactly opposite to that of the Ninth Circuit. The Fourth Circuit properly interpreted the applicable regulations as requiring an initial inquiry into the reasonableness of the amount of the compensation for services and disallowing deductions for only those payments which exceeded reasonable compensation for services actually performed. It declined to follow the Commissioner's position that a lack of compensatory intent alone was sufficient to deny a claimed compensation deduction. There is no all-or-nothing rule which precludes an examination of the reasonableness of the amounts of compensation paid for services performed. Rather, it is only the excess of purported compensation payments over reasonable compensation for services rendered that is not allowed as a compensation deduction. The apportionment of compensation payments into those which are deductible and those which are not is **required** by the applicable regulations.

2. The Rule of the Fifth Circuit

In *Owensby & Kritikos, Inc. v. Commissioner,* 819 F.2d 1315, 1325 (5th Cir. 1987), two shareholder employees of three closely-held corporations disputed the Commissioner's determination that the amounts paid them exceeded reasonable compensation for services. The Fifth Circuit, applying a clearly erroneous standard, affirmed the trial court's finding that, based upon objective standards, the compensation paid to them should be apportioned between deductible compensation and a nondeductible dividend. In affirming the trial court's determination, the Fifth Circuit stated as follows:

"Any amount paid in the form of

> compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock." 819 F.2d at 1324 (citing Treas. Reg. §1.162-7(b)(1)).

That is, per the regulation cited, an objective test of reasonableness is applied, and, to the extent the compensation is reasonable and for services rendered, it is deductible. However, to the extent the compensation payments exceed the amount determined to be reasonable, or are not for services rendered, the excess payments are not deductible.

In *Owensby, supra,* the payments made to Owensby and to Kritikos corresponded exactly to their stockholdings. In discussing the correlation between the payments and the stockholdings, the Court states:

> "When the payments made are unquestionably at the high end of the spectrum of compensation paid within a field of work, the correlation between stockholdings and

> payments makes it necessary for the court to consider whether the payments are disguised dividends even if the shareholder-employees contributed services in proportion to their stockholdings. In such a case, it is not unreasonable for the court to conclude that a portion of the payments represent compensation for services and the remainder represents a disguised dividend. As noted before, the trial court must scrutinize payments made to shareholder-employees who control the corporation, especially when these payments are in proportion to stockholdings. **As the regulations explain, however, even payments made to shareholders in proportion to their ownership are, as a general rule, improper only if they are in excess of what is usually paid for similar services."** 819 F.2d at 1325 (citing Treas. Reg. §1.162-7(b)(1)) (Emphasis added).

The significance of the opinion in *Owensby, supra,* is that the reasonableness test was first used to determine the amount of deductible compensation; it was only the compensation claimed in excess of the amount determined to be reasonable and which was paid for services rendered that was disallowed. Contrary to the position taken by the Ninth Circuit, no independent, all-or-nothing "compensatory intent" test was applied to preclude an apportionment of the compensation payments.

The new all-or-nothing "compensatory intent" rule of the Ninth Circuit is squarely contradicted by the rules of both the Fourth Circuit and the Fifth Circuit. The new Ninth Circuit rule allows an independent all-or-nothing

"compensatory intent" test to preclude an objective analysis of the reasonableness of the compensation. Both the Fourth Circuit and the Fifth Circuit require an objective analysis of the reasonableness of the compensation for services, and they disallow deductions only for the amounts determined to be in excess of a reasonable amount for the services which were rendered. **In fact, there is no case in any Circuit Court that has adopted a rule such as that of the new Ninth Circuit rule; although they may use differing factors, all the courts that have addressed this issue have examined the reasonableness of the amount of compensation for the services rendered. None have applied an all-or-nothing rule.**

This conflict between the Fourth Circuit and the Fifth Circuit, on the one hand, and the Ninth Circuit, on the other, has enormous consequences for this Nation's economy. It has a paralyzing affect upon the compensation decisions of many thousands of closely held, privately owned corporations comprising a significant portion of the Nation's economy. It not only leaves those decisions open to the hindsight application of an independent all-or-nothing "compensatory intent" test by the Commissioner, but it also exposes many thousands of small corporations to the the uncertainty, time and expense of a judicial challenge to the Commissioner's determination.

This conflict between the Circuit Courts of Appeal urgently needs the review of this Court.

B. The Treasury Regulations Are Binding Upon The Commissioner, And They Require An Objective Test Of Reasonableness.

The Trial Court below did not address the applicable

Treasury Regulations; nor did the majority opinion of the Ninth Circuit. It is a principle of black-letter law, however, that properly enacted regulations have the force of law and are binding on the government until properly repealed. See *Accadi v. Shaughnessy*, 347 U.S. 260 (1954); *Flores v. Bowen*, 790 F.2d 740, 742 (9th Cir. 1986). It is therefore necessary to turn to the applicable regulations to see what they provide.

Section 1.167-7(a) of 26 CFR, which has not only been in effect for more than 40 years, but which is identical to a predecessor provision which was also in effect for many years, sets out the test of deductibility in the case of compensation payments. That test is whether they are reasonable and are in fact payments purely for services. As discussed above, the meaning of this test was directly addressed by the Fourth Circuit in *R. J. Reynolds Tobacco Co., supra*. It is also illustrated in 26 CFR §1.162-7(b)(1):

> "Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services [an objective test] and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of

earnings upon the stock."

As this Regulation makes clear, when a purported compensation payment to a shareholder-employee is not made for a compensatory purpose because it is "not in fact as the purchase price of services," the disguised dividend is not deductible. It also makes clear that the disguised dividend is "the excessive payment" because it is only the excessive payment of the purported compensation payment that is "not paid wholly for services rendered." Consequently, a determination must first be made of that portion, if any, of the purported compensation payment which is reasonable in amount and which is for services rendered. Only then can the amount of the excessive payment which should properly be disallowed be determined. Apportionment of compensation deductions between those which are deductible and those which are not is not only allowed, but it is necessary to effectuate the spirit and intent of the Federal income tax laws.

Just as 26 CFR §1.162-7(b)(1) provides that the excessive portion of purported compensation that is actually a disguised dividend will not be deductible by the corporation, the regulations also provide analogous treatment for the employee-shareholder. Only the excessive portion of the payment will be treated as a dividend rather than as compensation. 26 CFR §1.162-8.

The Ninth Circuit's rule creates a new and independent, all-or-nothing "compensatory intent" test that is not supported by the law. The failure of a corporation to satisfy this new test precludes any analysis of either the amount of the purported compensation payments or the nature of the services for which there were purportedly made. **In fact, a finding that there was no compensatory**

intent necessarily means that no services were provided. This is inconsistent with the considerable evidence of Blazick and Richter's extraordinary hard work and unique skills, and of the corporation's phenomenal growth and better-than-average performance due to their personal efforts. (App.at A-16 to A-18)

As discussed above, the applicable regulations require that a "reasonableness" test be applied to determine whether the amount of purported compensation is reasonable and whether the compensation payments are for services rendered. Any purported compensation payments in excess of an amount which is determined to be reasonable and which are not for services rendered are nondeductible, and only such excess payments are nondeductible.

CONCLUSION

The Ninth Circuit has gone far beyond existing precedent and has created a new and independent all-or-nothing "compensatory intent" test **which is unsupported by the law**. As a result, the compensation decisions of thousands, perhaps millions, of closely-held, private corporations must run the risk of a subjectively applied, separate and independent all-or-nothing "compensatory intent" test applied retroactively upon the audit of the corporation's Federal income tax returns. Such uncertainty for such a large segment of the economy cannot be tolerated. A Writ of Certiorari should issue to the Ninth Circuit to reverse and remand this case to the Tax Court with instructions, as in *Elliotts, Inc, supra,* to begin its analysis by looking at the reasonableness of the amount of compensation and whether it was paid for services rendered.

Respectfully submitted,

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O.S.A. & ASSOCIATES, INC. d.b.a. Olympic Screen Crafts

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent
No. 3533-95.

United States Tax Court..
June 30, 1997.

Daniel I. Casas, Diana T. Gendotti, and Sheila M. RIley,
for Petitioner

Paul J. Krug and Virginia J. Coffre
for Respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FOLEY, Judge:

By notice of deficiency dated December 5, 1994, respondent determined the following deficiencies and accuracy-related penalties:

Year	Deficiency	Penalty Sec 6662 (a)
1990	$130,182	$2,6036
1991	44,877	108,975
1992	413,649	82,730

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure

1. Whether petitioner, pursuant to section 162, is entitled to deduct certain compensation payments to shareholders in

amounts in excess of amounts determined by respondent. We hold that petitioner is not so entitled.

2. Whether petitioner, pursuant to section 6662 (a), is liable for accuracy-related penalties for negligence. We hold that petitioner is liable.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. O.S.C. & Associates, Inc. d.b.a. Olympic Screen Crafts was incorporated under California law in 1982. During the years in issue, petitioner's principal place of business was in Fremont, California. Allen Blazick is petitioner's chief executive officer, Janette Blazick (Allen Blazick's wife) is petitioner's secretary and treasurer, and Steven Richter (Mrs. Blazick's brother) is petitioner's vice president. Together the three constitute petitioner's board of directors.

Mr. Blazick is a resident of Fremont, California. He attended Armstrong College, where he received a bachelor's degree in business management and a master's degree in business administration. In January of 1970, while attending college, he purchased a silk-screen printing business From 1970 through 1972, he and his wife, Janette, conducted the business from their residence. He had no previous experience in the printing business but learned quickly. In 1982, Mr. Blazick incorporated the business under the name "O.S.C. & Associates, Inc. During the years in issue, Mr Blazick owned 90 percent of petitioner's stock and Mr. Richter owned 10 percent. Mr. Blazick expanded the business to include numerous printing processes and other services. During the years in issue, petitioner employed between 179 and 235 employees, including numerous managerial and supervisory personnel. Leo Rosi was petitioner's accountant. Messrs. Rosi and Blazick were classmates at Armstrong College, and in the late 1970's Mr. Blazick became Mr. Rosi's client. In 1988 or 1989, Mr. Rosi

advised Messrs. Blazick and Richter that petitioner should pay dividends. Their response to Mr. Rosi's advice discouraged Mr. Rosi from raising the issue in subsequent years. Petitioner has never declared or paid dividends.

In 1985, Mr. Rosi drafted an incentive compensation plan (the plan), applicable only to Messrs. Blazick and Richter, which was approved by the board of directors on October 7, 1985. The plan provided for the payment, after the close of the fiscal year, of compensation in cash and or promissory notes. Pursuant to the term of the plan, the first step is to calculate the "Adjusted Industry Gross Margin" . The adjusted industry gross margin, or hypothetical gross profit, is the gross profit petitioner would have made on its sales if its gross profit margin had equaled the printing industry's average gross profit margin (i.e., petitioner's sales x industry average gross profit percentage = hypothetical gross profit). This hypothetical gross profit is then compared to petitioner's actual gross profit for the year. The amount by which petitioner's actual gross profit exceeds the hypothetical gross profit constitutes the incentive compensation pool. The plan allocates the incentive compensation pool to Messrs. Blazick and Richter "According to Stock Ownership" (i.e., 90 percent to Mr. Blazick and 10 percent to Mr. Richter).

Under the plan, each allocation is reduced if certain contingencies occur. Mr. Blazick's allocation is reduced by inventory shortages in excess of $100,000 and by bad debts. Mr. Richter's allocation is reduced by inventory spoilage in excess of $100,000 and production rerun costs in excess of $100,000.

Petitioner operated on a fiscal year ending on October 31. Petitioner's financial statements for the years in issue delineated the following figures:

FYE 1990

Sales/revenue	$10,271,148.12
Cost of goods sold	(5,978,195.24)
Gross profit	4,292,952.88
Net income	192,865.38
Yearend net worth	194,490.31

FYE 1991

Sales/revenue	$13,115,588.55
Cost of goods sold	(7,324,963.44)
Gross profit	5,790,625.11
Net income	134,160.16
Yearend Net Worth	328,650.47

FYE 1992

Sales/revenues	$12,310,770.53
Cost of Goods Sold	5,981,916.36
Gross profit	6,328,854.17
Net income	143,809.07
Yearend net worth	142,459.54

Mr. Rosi calculated the compensation due under the plan. In calculating the compensation, he referred to information published annually in a survey of small businesses (the Survey). For the 1990 calculation, he used 32.189 percent as the industry average gross profit margin. For that year,

the Survey reported a 34.93 percent industry average. For the 1991 calculation, he again used the 1990 industry average (i.e., 32.189 percent) rather than the 1991 industry average. In the 1990 and 1991 calculations, he used figures from a sample of printing companies categorized according to the amount of their sales. In 1992, however, he used figures from a sample of printing companies categorized according to the value of their assets. In addition, he used a chart applicable to companies with assets under $1 million when petitioner had assets in excess of that amount. Also in 1992, petitioner incurred bad debts of $166,700. Before adjusting Mr. Blazick's allocation, however, Mr. Rosi reduced the bad debts figure to $112,403.

During the years in issue, petitioner paid, in the form of cash and promissory notes, the following amounts to Messrs. Blazick and Richter:

	1990	1991	1992
Allen Blazick			
Salary	$155,372	$175,845	$173,372
Incentive	490,859.92	1,651,145.7	1,324,608
Total	$646,231.92	1,826,990.76	1,497,980
Steven Richter			
Salary	$ 57,791	$64,616	$60,000
Incentive	98,035.62	183,460.64	149,179
Total	$155,826.62	$248,076.64	$209,179

For each year in issue, petitioner filed a Form 1120 (U.S. Corporation Income Tax Return) and claimed a deduction for the compensation paid to Messrs. Blazick and Richter. Respondent, in the notice of deficiency, disallowed $357,453 of petitioner's 1990 deduction, $1,580,631 of petitioner's 1991 deduction, and $1,1989,677 of petitioner's 1992 deduction. The petition in this case was filed on March 6, 1995.

OPINION

I. Deductibility of Plan Payments

Section 162(a) provides that a taxpayer may deduct all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Such expenses may include "a reasonable allowance for salaries or other compensation for personal services actually rendered." Sec. 162(a)(1); sec. 1.162-7(a), Income Tax Regs.. For such an expense to be deductible, two elements must be present: (1) The amount must be reasonable, and (2) the expense must relate to compensation for services actually rendered. Elliotts, Inc. v. Commissioner, 716 F. 2d 1241, 1243 (9th Cir.. 1983), revg.. T.C. Memo. 19809-282. Where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, we may expand our inquiry into the existence or nonexistence of compensatory intent. Id. at 1244; see also Ruf v. Commissioner, T.C. Memo. 1993-81, affd. without published opinion 57 F.3d 1078 (9th Cir.. 1995).

Numerous factors in the present case lead us to conclude that the plan allocations were not intended as compensation for services rendered. First, in 1990, 1991 and 1992, petitioner paid Messrs. Blazick and Richter salaries and bonuses totaling approximately 81 percent, 94 percent, and 92 percent, respectively, of petitioner's net income (i.e., calculated by adding back compensation). Such high percentages are consistent with the existence of disguised dividends. See Pacific Grains, Inc. v. Commissioner, 399 F.2d 603 (9th Cir.. 1968), affg. T.C. Memo. 1967-7.

Second, petitioner has never declared or paid a dividend. While the U.S. Court of Appeals for the Ninth

Circuit has indicated that this fact is not dispositive, Elliotts, Inc. v. Commissioner, supra at 1246, it is a relevant consideration, Owensby & Kritikos, Inc. v. Commissioner, 819 F. 2d 1315, 1324 (5th Cir.. 1987) , affg. T.C. Memo. 1985-267; Nor-Cal Adjusters v. Commissioner, 503 F. 2d 359, 362 (9th Cir.. 1974), affg. T.C. Memo. 1971-200. Mr. Rosi testified that in 1988 or 1989 he advised petitioner to pay dividends and that Messrs. Blazick and Richter's response discouraged him from offering such advice during the years in issue. Mr. Blazick, however, when asked why petitioner did not pay dividends, testified that dividends were not paid "Because Mr. Rosi prepared a procedure for us to follow and we did."

Third, Mr. Rosi's implementation the plan had the effect of arbitrarily increasing allocations above the amounts the plan authorized. This occurred in 1990 and 1991 when Mr. Rosi utilized industry average gross profit margins lower than those published in the Survey. and in 1992 when Mr. Rosi reduced the bad debts to Mr. Blazick's 1992 allocation. Mr. Rosi offered no explanation for these apparent manipulations.

Finally, the most persuasive evidence of petitioner's lack of compensatory intent is the plan itself. Consistent with the existence of disguised dividends, the plan applied only to petitioner's shareholders, Messrs. Blazick and Richter, and payments were expressly calculated with reference to their proportion of stock ownership. See Elliotts, Inc. v. Commissioner, supra at1246-1247 & nn. 4, 7. Moreover, the plan does not use the value of services rendered as the basis for calculating the amount of compensation. but merely distributed excess profits to Messrs. Blazick and Richter.

Generally, incentive compensation plans are designed to increase the compensation to employees by some fraction

of the benefits the corporation derives from the employees, efforts. See Elliotts, Inc. v. Commissioner, supra at 1248 (stating that "Incentive payment plans are designed to encourage and compensate that extra effort and dedication which can be so valuable to a corporation."); cf. Kennedy v. Commissioner, 671 F.2d 167 (6th Cir.. 1982), rev.. 72 T.C. 793, 1979 WL 3748 (1979) (concerning incentive compensation equal to 52 percent of net profits); PMT, Inc. v. Commissioner, T.C. Memo. 1996-303 (concerning incentive compensation equal to 10 percent of the increase in sales over the previous year's sales). As the benefit to the corporation increases, compensation to the employee increased. Dividends, on the other hand, are merely distributions of excess earnings to shareholders in proportion to their stock holding.

Petitioner's plan provides that every dollar of gross profits in excess of the hypothetical gross profit goes directly to Messrs. Blazick and Richter while petitioner receives nothing.. The allocations are measured by the amount of petitioner's excess gross profits and not by the value of Messrs. Blazick's and Richter's contributions to petitioner. We also note that the adjustments (i.e., relating to bad debts, inventory spoilage, production rerun costs, and inventory shortages) made to the allocations merely reduce the distributions to Messrs. Blazick and Richter without direct relation to the value of their services.

Accordingly, we conclude that the plan allocations were not made with compensatory intent and thus did not constitute compensation for services. As a result, we sustain respondent's determination for each year.

II. Negligence Penalty

Section 6662 (a) imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of any

underpayment to which the section applies. The section applies to, among other items. the portion of an underpayment attributable to negligence or disregard of rules or regulations. Sec.6662 (b) (1). Negligence has been defined as the lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947, 1985 WL 15422 (1985). It includes the failure to make a reasonable attempt to comply with the Internal Revenue Code. Sec. 6662 (c) . In determining whether a corporation is liable for the negligence penalty, the acts of officers on behalf of the corporation are imputed to the corporation. DiLeo v. Commissioner, 96 T.C. 858, 875, 1991 WL 108769 (1991), affd. 959 F. 2d 16 (2d Cir.. 1992); Auerbach Shoe Co. v. Commissioner, 21 T.C. 191, 194, 1953 WL 273 (1953), affd. 216 F. 2d 693 (!st Cir.. 1954); Ibabao Med. Corp. v. Commissioner, T.C. Memo. 1988-285.

We conclude that petitioner failed to exercise ordinary care. The record established that the plan was both designed and manipulated to direct the flow of corporate earnings to Messrs. Blazick and Richter and to disguise such payments as compensation.

We have considered all other arguments made by the parties and found them to be either irrelevant or without merit.

To reflect the foregoing.
Decision will be entered for respondent.

O.S.C. & ASSOCIATES, INC., d.b.a. Olympic Screen Crafts,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 97-71199.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted Jan. 15, 1999.

Decided Aug. 16, 1999.

Corporate taxpayer challenged disallowance, by Internal Revenue Service (IRS), of deductions that allegedly represented compensation to employees. The United States Tax Court, Maurice B. Foley, J., entered judgment for defendant Commissioner of Internal Revenue, and taxpayer appealed. The Court of Appeals, Silverman, Circuit Judge, held that: (1) payments made to employee-shareholders were dividends in disguise, and (2) assessment of negligence penalty was not improper.

Affirmed.

Wiggins, Circuit Judge, filed dissenting opinion.

[1] INTERNAL REVENUE $ 3321
220k3321
Although Internal Revenue Code permits a corporation to deduct a reasonable allowance for salaries or other compensation for services personally rendered, the payment of dividends to shareholders is not deductible. 26 U.S.C.A. § 162(a)(1).

[1] INTERNAL REVENUE $ 3740.1
220k3740.1
Although Internal Revenue Code permits a corporation to deduct a reasonable allowance for salaries or other compensation for services personally rendered, the payment of dividends to shareholders is not deductible. 26 U.S.C.A. § 162(a)(1).

[2] INTERNAL REVENUE $ 3321
220k3321
When corporation makes payments to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory and thus deductible: first, the amount of compensation must be reasonable, and, second, the payment must be purely for services, or have a purely compensatory purpose. 26 U.S.C.A. § 162(a)(1).

[2] INTERNAL REVENUE $ 3323
220k3323
When corporation makes payments to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory and thus deductible: first, the amount of compensation must be reasonable, and, second, the payment must be purely for services, or have a purely compensatory purpose. 26 U.S.C.A. § 162(a)(1).

[2] INTERNAL REVENUE $ 3753
220k3753
When corporation makes payments to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory and thus deductible: first, the amount of compensation must be reasonable, and, second, the payment must be purely for services, or have a purely compensatory purpose. 26 U.S.C.A. § 162(a)(1).

[3] INTERNAL REVENUE $ 4730
220k4730
Factual findings of the Tax Court are reviewed for clear error.

[4] INTERNAL REVENUE $ 3321
220k3321
Corporate taxpayer's payments to its two employee-shareholders under "incentive compensation plan" were dividends in disguise, not payments of compensation, and thus were not deductible by taxpayer, regardless of whether payments could be justified as reasonable, in view of evidence that percentages of taxpayer's net income paid to its two employee-shareholders were high, that taxpayer never paid a dividend, that plan was manipulated to increase allocations, and that design of plan itself was inconsistent with compensatory intent. 26 U.S.C.A. § 162(a)(1).

[4] INTERNAL REVENUE $ 3753
220k3753
Corporate taxpayer's payments to its two employee-shareholders under "incentive compensation plan" were dividends in disguise, not payments of compensation, and thus were not deductible by taxpayer, regardless of whether payments could be justified as reasonable, in view of evidence that percentages of taxpayer's net income paid to its two employee-shareholders were high, that taxpayer never paid a dividend, that plan was manipulated to increase allocations, and that design of plan itself was inconsistent with compensatory intent. 26 U.S.C.A. § 162(a)(1).

[5] INTERNAL REVENUE $ 3377
220k3377
If there is evidence that corporation's purportedly compensatory payments to employees contain disguised dividends, the corporation must separately show both that amount of compensation is reasonable and that payments have purely compensatory purpose to avoid characterization of payments as nondeductible dividends; reasonableness alone will not suffice. 26 U.S.C.A. § 162(a)(1).

[5] INTERNAL REVENUE $ 3378
220k3378
If there is evidence that corporation's purportedly compensatory payments to employees contain disguised dividends, the corporation must separately show both that amount of compensation is reasonable and that payments have purely compensatory purpose to avoid characterization of payments as nondeductible dividends; reasonableness alone will not suffice. 26 U.S.C.A. § 162(a)(1).

[6] INTERNAL REVENUE $ 4657
220k4657
Once an underpayment of taxes is established, determination by Commissioner of Internal Revenue that underpayment was due to negligence is presumptively correct and must stand unless taxpayer can establish that it was not negligent.

[7] INTERNAL REVENUE $ 4739
220k4739
Court of Appeals reviews for clear error Tax Court's determination that taxpayer's underpayment was attributable to negligence.

[8] INTERNAL REVENUE $ 3377
220k3377
Corporate taxpayer failed to rebut presumption that its underpayment of taxes was due to negligence, where taxpayer deducted payments that were in fact dividends to employee-shareholders, and there was evidence that taxpayer's incentive compensation plan was designed to direct flow of corporate earnings to its shareholders and that taxpayer ignored advice of its accountant to pay dividends.

[8] INTERNAL REVENUE $ 3778
220k3778
Corporate taxpayer failed to rebut presumption that its underpayment of taxes was due to negligence, where taxpayer deducted payments that were in fact dividends to employee-

shareholders, and there was evidence that taxpayer's incentive compensation plan was designed to direct flow of corporate earnings to its shareholders and that taxpayer ignored advice of its accountant to pay dividends.

*1117 Daniel L. Casas, Reynolds Price Casas & Riley, Los Altos, California for the petitioner-appellant.

Loretta C. Argrett, Tax Division, United States Department of Justice, Washington, D.C., for the respondent-appellee.

Appeal from the United States Tax Court, Maurice B. Foley, Judge, Presiding. Tax Court No. 3522-95.

Before: WIGGINS, TASHIMA and SILVERMAN, Circuit Judges.

SILVERMAN, Circuit Judge:

A corporation's payment of compensation to employees is tax deductible by the corporation; its payment of dividends to shareholders is not. In this case, we once again examine the circumstances under which deductions for payments to shareholder-employees of a closely-held corporation, ostensibly as compensation for services, will be disallowed as disguised dividends. In Elliotts, Inc. v. Commissioner, 716 F.2d 1241(9th Cir.. 1983) we applied a two-part test to determine *1118 the deductibility of such payments; reasonableness of amount and compensatory intent. We said, "in the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness." Id. as 1244.

This is such a case. We affirm the tax court's finding that OSC's payments to Blazick and Richter, whether or not reasonable in amount, were not intended as compensation. They were dividends in disguise.

FACTUAL AND PROCEDURAL BACKGROUND

In 1970, Allen Blazick bought a silk-screen business for $180.00. He and his wife operated the business on a part-time baises from the two-bedroom apartment while he continued to go to school and work at a bank during the day. As the business grew, Blazick hired Steven Richter, his brother-in-law, to assist with manufacturing. He was paid $2.00 per hour when they could afford it. In 1976, Blazick and Richter's enthusiasm, energy and hard work started to pay off--Blazick landed Safeway Stores as a client. It is undisputed that Blazick and Richter continued to bring their extraordinary talent, dedication, and energy to the business, and it is undisputed that the business prospered remarkably as a direct result of their personal efforts. By 1991, Olympic Screen Crafts had moved from Blazick's kitchen table to a 65,000 square-foot plant, had over 200 employees, and grossed over $13 million a year.

In 1982, the business was incorporated. Blazick became OSC's President and Chief Executive Officer, and owned 90% of its stock; Richter became OSC's Vice President, and was issued the remaining 10% of its stock. Blazick's wife served as the secretary and treasurer.

Three years after OSC incorporated, it adopted an incentive compensation plan. According to OSC, its purpose was "to recognize and compensate Blazick and Richter for their distinct and different contributions to the business." The incentive plan was developed by Leo Rosi, Blazick's college acquaintance and OSC's long-time certified public accountant. Blazick and Richter were the plan's only participants. Under the terms of the plan, the amount of incentive compensation was to be determined at the end of each fiscal year by first calculating a hypothetical gross margin. The gross margin was calculated by multiplying OSC's actual total sales by an adjusted industry gross margin ratio. The total incentive compensation pool consisted of the difference between OSC's actual gross margin and the hypothetical adjusted industry gross margin.

The plan expressly provided that payments from the incentive compensation pool would be made "according to stock ownership." It directed that after specific deductions were taken from each participant's share, 90% of the total incentive compensation pool would be allocated to Blazick, with the remaining 10% going to Richter. Each year, Blazick's incentive compensation was to be reduced by any inventory shortages in excess of $100,000 and by any bad debts. Likewise, Richter's incentive compensation was to be reduced by inventory spoilage in excess of $100,000 and production costs of $100,000. As a practical matter, this formulation resulted in the corporation distributing nearly all (between 82% and 94%) of its net income as incentive payouts to Blazick and Richter in the years in question. All of the incentive compensation paid out to Blazick and Richter was deducted as compensation under § 162(a) of the internal Revenue Code. The IRS disallowed a substantial *1119 portion of those deductions. [FN1]

FN1. For the tax years at issue, OSC paid Blazick and Richter the following base salaries and bonuses pursuant to the incentive plan:

	1990	1991	1992
Blazick			
Base Salary	$155,372	175,485	173,372
Incentive Distribution	$490,860 (83%)	1,651,146 (90%)	1,324,608 (90%)
TOTAL	$646,232	1,826,631	1,497,980

	1990	1991	1992
Richter			
Base Salary	$57,791	64,616	60,000
Incentive Distribution	$98,036 (17%)	183,461 (10%)	149,179 (10%)
TOTAL	$155,827	248,779	209,179
Total Compensation Claimed Deductible	$802,058	2,075,068	1,707,159
Amount Disallowed by IRS	$357,453	1,580,631	1,198,677
Amount Allowed by IRS	$444,606	494,437	508,482

The numbers in brackets reflect the percentage of the distribution from the incentive plan that each shareholder received during the respective tax years.

As the company's accountant, Rosi performed the hands-on implementation of the plan. He acknowledged that the method he used to calculate the corporation's cost of goods sold was not in accordance with generally accepted accounting principles. He also testified that in 1990 and 1991, he "miscalculated" OSC's gross profits resulting in an arbitrary increase to the incentive compensation pool. He also acknowledged his failure to make

other adjustments required by the plan, thus increasing the distributions to Blazick and Richter.

OSC never paid or declared a dividend, despite the fact that in 1988 or 1989, the years immediately following the incentive plan's implementation, Rosi specifically advised OSC to pay them. Rosi testified that Blazick was strongly opposed to the idea. Rosi testified that because of Blazick's reaction to his advice, he never brought it up again. Blazick's antipathy to dividends also was reflected in a credit memorandum prepared by an officer of Union Bank in 1992. It contained the following statement:

> [Blazick's] salary for 1991 was over $1.8MM. The reasoning behind the higher salary is taxable income. Mr. Blazick does not intend to be taxed twice for the profitability of his business. He contends taking the higher salary will increase his personal tax liability, but this rate is lower than the corporate tax rate.For each of the tax years in issue, OSC deducted the full amounts paid to Blazick and Richter under the incentive plan. The IRS disallowed most but not all of it. The IRS assessed back taxes on the disallowed amounts and assessed an accuracy-related penalty pursuant to 26 U.S.C. § 6662(a). [FN2]
>
> FN2. OSC does not raise and we do not address any apportionment issue, i.e., whether any further portion of the disallowed part of the incentive compensation should have been allowed as reasonable compensation. OSC's contention is that the entirety of the claimed amounts of incentive compensation should have been allowed.

At trial before the Tax Court, OSC offered considerable evidence of Blazick and Richter's extraordinary hard work and unique skills, and of the corporation's phenomenal growth and better-than-average performance due to their personal efforts. Nevertheless, The Tax Court found that the plan allocations were not made with compensatory intent. It found that the plan "was both designed and manipulated to direct the flow of earnings to

Messrs. Blazick and Richter and to disguise such payments as compensation." On that basis, it also upheld the imposition of a penalty for negligence.

I Deductibility of Compensation

[1][2][3] Section 162(a)(1) of the Internal Revenue Code permits a corporation to deduct "a reasonable allowance for salaries or other compensation for services personally rendered." 26 U.S.C. § 162(a)(1). The payment of dividends to shareholders, however, is not deductible. When payments *1120 are made to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory. First, the amount of compensation must be reasonable; second, the payment must be purely for services, or have a purely compensatory purpose. Elliotts, 716 F.2d at 1243; Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 361-62 (9th Cir.. 1974). Factual findings of the Tax Court are reviewed for clear error. Delk v. Commissioner, 113 F.3d 984, 986 (9th Cir.. 1997). The clear error rule applies to the "Tax Court's findings of fact, derived from application of the appropriate factors." in disguised dividend cases. See Elliotts, 716 F.2d at 1245.

In Nor-Cal, a closely-held corporation that had never declared or paid dividends deducted as compensation "bonuses and administrative salary" paid to its president, vice-president, secretary and treasurer who, together, owned 100% of the company's stock. "Each of the bonus payments and administrative salary made by Nor-Cal to its four officer-shareholders during the year in issue was exactly proportionate to the recipients stock holding in Nor-Cal." Id. at 361. We affirmed the Tax Court's ruling that the payments in issue were disguised dividend distributions rather than payment for services rendered, id. at 362, and we upheld its reliance on the following factors:

1. The bonuses were in exact proportion to the officers' stock holdings.
2. Payments were in lump sums rather than as the services were rendered.
3. There was a complete absence of formal dividend distributions by and expanding corporation.
4. The system of bonuses was completely unstructured having no relation to services performed.
5. The company's consistently negligible taxable income was an indication that the bonus system was based on funds available rather than on services rendered.
6. Bonus payments were made only to the four officer-stockholders, no other employees. Id. at 362

We addressed this problem again in Elliotts. There, the corporation paid Edward-Elliot, who was both its CEO and only shareholder, a $24,000 annual salary plus a year-end bonus of 50% of net profits. The total paid by Elliotts, Inc. to Edward Elliott approached $200,000 a year, which the corporation deducted in full as compensation. The IRS determined that this amount exceeded what could be deemed reasonable compensation, that it contained a disguised dividend, and that only $65,000 a year could be deducted as payment for services.

On appeal, we started with the premise that under § 162(a)(1), a corporation may deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." We also acknowledged the two-prong test for deductibility: "(1) the amount of the compensation must be reasonable and (2) the payments must in fact be purely for services." 716 F.2d at 1243. We noted that intent is subjective and difficult to prove and usually can be inferred if the amount is reasonable, but not necessarily so.

The existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable under the first prong. For these reasons,courts generally concentrate on the first prong-- whether the amount of the

purported compensation is reasonable. Courts have generally not delved into whether a compensatory purpose exists under the second prong except in those rare cases where the Commissioner has come forward with evidence that purported compensation payments, although reasonable in amount, were in fact disguised dividends. Id. (internal citations omitted) (emphasis added).

*1121 We specifically held that "where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from the reasonableness." Id. at 1244.

[4][5] That brings us to the present case. OSC would have had the Tax Court fixate entirely on the reasonableness of the amounts involved and then draw an inference of compensatory intent, without regard to the other evidence. However, as we recognized in Elliotts, if there is evidence that the payments contain disguised dividends, the corporation must separately satisfy both the reasonableness and the compensatory intent prongs of the test. Reasonableness alone will not suffice.

The Commissioner did indeed come forward with overwhelming evidence of disguised dividends, evidence that fully supported the Tax Court's conclusion that the plan allocations were not intended as compensation, regardless of whether the amounts could be justified as reasonable. The Tax Court relied on several factors in finding disguised dividends in this case:

First, the percentages of OSC's net income paid to its two employee-shareholders was high, between 81% and 94% during the years in question. As we observed in Elliotts, if the bulk of corporate earnings are paid out as bonuses or the like, that is a strong indication that profits are being siphoned out of the company disguised as compensation. See id. at 1243.

Second, OSC never paid or declared a dividend. Although not a dispositive factor, it is relevant in light of the history of profitability and Rosi's rejected advice to pay dividends.
Third, Rosi manipulated the actual implementation of the plan to

increase the allocations above what the plan itself authorized.

Fourth, the design of the plan itself was inconsistent with compensatory intent: (a) It applied only to the corporation's shareholders and no other employees; (b) payments were calculated with reference to their proportionate stock ownership; and (c) the method of calculation was not based on the value of services rendered, but was structured to distribute every dollar of gross profits in excess of the hypothetical gross profit.

Because these findings are not clearly erroneous, the Tax Court's determination that OSC's incentive plan payments were not made with compensatory intent must be affirmed. [FN3]

FN3. Because we affirm the Tax Court's finding on lack of compensatory intent, we need not address OSC's evidentiary objections relating to the evidence of reasonableness.

II Negligence Penalty

[6][7] OSC contends that the Tax Court clearly erred in concluding that its underpayment was attributable to negligence. Once an underpayment of taxes is established, the Commissioner's determination that under-payment was due to negligence is presumptively correct and must stand unless OSC can establish that it was not negligent. See Hall v. Commissioner, 729 F.2d 632, 635 (9th Cir.. 1984). This Court reviews the Tax Court's determination for clear error, Wolf v. Commissioner, 4 F.3d 709, 715 (9th Cir.. 1993).

[8] The Tax Court concluded that OSC failed to exercise ordinary care in attempting to comply with the Internal Revenue Code. The record establishes that OSC's incentive plan was designed to direct the flow of corporate earnings to its shareholders. Further, OSC ignored the advice of its accountant to pay dividends. Because OSC has presented insufficient evidence to overcome the presumption of negligence, we affirm the Tax Court's penalty assessment.

AFFIRMED.

WIGGINS, Circuit Judge, dissenting:

I respectfully dissent from the well-written Majority Opinion. I believe that an apportionment between the allowed amount for deductible compensation and non-deductible disguised dividend payments *1122 was required in this case. Although the Majority's affirmance of the Tax Court creates a de facto apportionment, I believe that the regulations entitled the taxpayer to an apportionment by the Tax Court as part of the Tax Court's redetermination of the taxpayer's tax liability.

I

It cannot be doubted that the so-called "incentive compensation plan" developed by the taxpayer was nothing more than a ham-handed attempt to characterize distributions of corporate profits, which otherwise are nondeductible dividend payments, as compensation payments to the shareholder-employees Blazick and Richter. The Majority correctly finds that the Commissioner provided "overwhelming evidence of disguised dividends". Maj. Op. at 1120-21. Given this showing by the Commissioner, there are two issues on appeal. The first issue is whether the taxpayer can deduct some portion of the incentive compensation payments, even though the payments contained disguised dividends. The second issue is what the Tax Court was required to do in determining what amount of the incentive compensation payments, if any, was deductible as reasonable compensation, even though the incentive compensation payments contained disguised dividends. The relevant Treasury Regulations make clear that the taxpayer is allowed a deduction for that portion of the incentive compensation payments equivalent to a reasonable compensation, even though the purported compensation payments were not made solely for a compensatory purpose. In light of what occurred during the proceedings in the Tax Court, after the Tax Court determined that the purported compensation payments were not made requisite compensatory intent, that court was obligated: (1) to determine the amount equal to a reasonable

compensation; (2) to allow the taxpayer a deduction for that amount; and (3) then to disallow the deduction for the amount of the payments that exceeded that reasonable amount. For some unknown reason, the Tax Court ignored its obligations and affirmed the Commissioner's determination. By misunderstanding, or ignoring, the relevant Treasury Regulations, the Tax Court managed to affirm the Commissioners determination even after the Commissioner conceded that substantially more compensation should have been reasonable than was allowed in the notice of deficiency. Because the Tax Court's approach was inconsistent with the relevant Treasury Regulations, I would reverse the Tax Court. [FN1]

FN1. The Majority suggest that O.S.C. has not raised the apportionment issue. I believe that this conclusion, though understandable because of the poor quality of the parties' briefs, is mistaken and that O.S.C. raised the apportionment issue. I believe that the difficulty concerning what O.S.C. actually raised in its brief results from O.S.C.'s reliance upon our opinion in Elliotts Inc. v. Commissioner, 716 F.2d 1241 (9th Cir.. 1983), as the basis of the required apportionment, rather than the Treasury Regulations. In Elliotts, we held that when the Tax Court was faced with disguised dividends that involved unreasonable compensation, the Tax Court should determine the reasonable amount of compensation, allow a deduction for the reasonable amount and disallow the deduction to the extent the payments exceeded the reasonable amount. See Elliotts, 716 F.2d at 1248. O.S.C., relying upon decision in Elliotts, has claimed that the Tax Court should have utilized the five-factor test established in Elliotts and allowed a deduction of the reasonable amount of compensation paid to Blazick and Richter. Although this argument was somewhat opaque in Appellant's Opening Brief, the Commissioner clearly understood the argument and responded that no apportionment is required if the payments were made without compensatory intent: "As is evident throughout

taxpayer's brief, taxpayer apparently fails to comprehend the ultimate basis for the Tax Court's opinion in the case, which is that regardless of whether the payments in issue here were reasonable in amount, they were nonetheless not deductible because they constituted disguised dividends instead of compensation for services actually rendered.". Appellee's Brief at 20-21. O.S.C.'s position, which the Commissioner had already responded to in its own brief, was made relatively more clear in O.S.C.'s reply brief: "Even if, as Appellee argues, the Tax Court disposed of this case on the second prong of the test, the Court first had to find of [sic] what amount of compensation O.S.C. could reasonably pay to Blazick and Richter for the personal services they rendered." Appellant's Reply Brief at 10. Therefore, I believe that the issue of apportionment was sufficiently raised for us to consider it.

*1123 II
An Apportionment Was Required

The taxpayer, relying upon our decision in Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir.. 1983), claims that even if the incentive compensation payments were disguised dividends, it should be allowed a deduction for an amount equivalent to the reasonable compensation that would have been paid to Blazick and Richter. [FN2] The taxpayer's reliance on our opinion in Elliotts is misplaced because our Elliotts opinion addressed the appropriate analysis in cases involving payments made with compensatory intent that were unreasonable in amount. Nevertheless, the relevant Treasury Regulations make clear that even if purported compensation payments were made without the requisite compensatory intent, the taxpayer is still entitled to a deduction equivalent to the reasonable amount of compensation paid to the shareholder-employees.

FN2. Incredibly, the taxpayer's counsel has continued to claim that all of the incentive compensation payments

were reasonable compensation. Although this type of vigorous advocacy is understandable, it has done the taxpayer a grave disservice. By claiming that the taxpayer is entitled to deduct all of the incentive compensation payments, the taxpayer has convinced the Majority that this is an all-or-nothing case: either the payments were deductible or they were not. As will be explained in more detail, the relevant Treasury Regulations make this case into something other than an all-or-nothing case. The taxpayer's unreasonable position, however, has cost it the chance to deduct a reasonable amount of compensation because it has confused the Majority and failed to explain the relevant Treasury Regulations.

Section 162(a) of the Internal Revenue Code ("Section 162") allows an employer-taxpayer a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." 26 U.S.C. § 162(a)(1). In Elliotts, this court indicated that "[t]here is a two-prong test for deductibility under section 162(a)(1): (1) the amount of the compensation must be reasonable and (2) the payments must in fact be purely for services." Elliotts, 716 F.2d at 1243. We also recognized that with this two-prong test "[p]roof of the second prong, which requires a 'compensatory purpose', can be difficult to establish because of its subjective nature" and that therefore "[b]y and large, the inquiry under section 162(a)(1) has turned on whether the amounts of the purported compensation payments were reasonable." Id. at 1243-1244. While the court's inquiry will normally concentrate on the first prong of the test for deductibility, the reasonableness of the compensation payments, the Elliotts court explicitly reserved the possibility that the court's determination could be based solely on the second prong, the compensatory purpose of the payments: "[i]n the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness." Id. at 1245. As the Majority Opinion makes clear, "[t]his is [the rare] case" that we envisioned in Elliotts. Maj. Op. at 1118. We, therefore, must decide whether a taxpayer is

entitled to deduct any of a purported compensation payment, when the payment was not made wholly for the requisite compensatory purpose. Although we never addressed this issue in Elliotts, the Treasury Regulations and existing precedent indicates that the taxpayer is entitled to deduct a portion of the purported compensation equivalent to a reasonable amount of compensation.

The Section 162 Treasury Regulations, which were not addressed in the Tax Court's opinion, indicate that even if purported compensation payments not made solely for a compensatory purpose, only the portion of the payments that exceeds the reasonable amount of compensation is not deductible:

> *1124 Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. this is likely to occur in the case of a corporation have few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services [FN3] and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings on the stock.
>
> FN3. This is an objective measure of reasonable compensation. See 26 CFR §1.162-7(b)(3) ("It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."). It is this objective determination that may have posed a problem for the Tax Court in this case because the Commissioner's own compensation expert indicated that a significant increase in the compensation allowed by the Commissioner would have been called for.

26 CFR §1.162-7(b)(1)(emphasis added). [FN4]

> FN4. Thus under the Treasury Regulations, there is a two-pronged test for deductibility of a purported compensation payment: (1) reasonableness of amount: and (2) compensatory purpose. Under either prong of this test, however, a similar analysis is applied to determine which portion, if any, of the payment is deductible. If the payments exceed the reasonable amount of compensation, the taxpayer is allowed a deduction for the reasonable amount of compensation, but not for the excessive portion. See Elliotts, 716 F.2d at 1248. If the payments were a distribution of corporate profits rather than for a compensatory purpose, the taxpayer is allowed a deduction for an amount equivalent to the reasonable amount of compensation, but not for the portion of the payment that exceeds the amount. See Treas. Reg. § 1.162-7(b)(1).

As this Regulation makes clear, when a purported compensation payment to a shareholder-employee is not made for a compensatory purpose, because the payment is "not in fact as the purchase price of services", the disguised dividend is not deductible. The Regulation also makes clear that the disguised dividend is "the excessive payment" because it is the excessive portion of the purported compensation payment that is "not paid wholly for services rendered." It is the excessive portion of the purported compensation payment that is actually "a distribution of earnings upon the stock." Consequently, a determination must be made of the reasonable compensation to be paid to the shareholder-employee. Then the excessive portion of the purported compensation payment can be disallowed as a disguised dividend.

Just as the Section 162 Regulations provide that the excessive portion of purported compensation that is actually a disguised dividend will not be deductible by the corporation, the regulations also provide analogous treatment for the employee-recipient. The

regulations indicated that only the excessive portion of the payment will be treated as a dividend rather than as compensation:

> The income tax liability of the recipient in respect to an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances in each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. 26 CFR § 1.162-8 (emphasis added).

Although this Circuit has not addressed in a published opinion whether a portion of a purported compensation payment is nevertheless deductible, notwithstanding that the payment was not made solely for a compensatory purpose, the Fifth Circuit has addressed this issue and concluded that the purported compensation should be apportioned between deductible and nondeductible amounts:

> *1125 When the payments made are unquestionably at the high end of the spectrum of compensation paid within a field of work, the correlation between stock holdings and payments makes it necessary for the court to consider whether the payments are disguised dividends even if the shareholder-employees contributed services in proportion to their stock holdings. In such a case, it is not unreasonable for the court to conclude that a portion of the payments represent compensation for services and the remainder represents a disguised dividend . . . As the regulations explain, . . . even payments made to shareholders in proportion to their ownership are, as a general rule, improper only if they are in excess of what is usually paid for similar services. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1325 (5th Cir.. 1987) (citing by footnote Treas. Reg. 1.162-7(b)(1)(emphasis added).

In addition, a rather dated opinion of the Fourth Circuit, interpreting the predecessor provisions in the Internal Revenue Code of 1933, explains the merits of an apportionment approach:

> If there is a reasonable basis in the record for isolating that part of the payment which is reasonable compensation for services, we think that a deduction for that part should be allowed. This is true whether the excess is classified as unreasonable compensation or as dividends. There is no basis in reason, the Tax Code, or administrative practice for the insistence that the part which is not deductible fatally infects the part which clearly is. Commissioner v. R.J. Reynolds Tobacco Company, 260 F.2d 9, 12 (4th Cir.. 1958).

Although our circuit has had only limited opportunity to address the Section 162 Regulations in published opinions, what little we have said has indicated that an apportionment is required. For example, in Harolds Club v. Commissioner, 304 F.2d 861 (9th Cir.. 1965), we rejected a taxpayer's strained reading of the regulations, but said that "[t]he fact that the regulation quoted in note 6 [Treas. Reg. §1.162-7(b)(1)] singles out cases where a salary is disallowed in part because it is a disguised dividend or payment for property does not alter the requirement that the salary be reasonable to be deductible." Harolds Club, 340 F.2d at 867 (emphasis added). This approach to the deductibility of purported compensation payments, which would disallow the deduction only for a portion of the payment, was repeated in our Elliotts opinion, where we indicated that "a taxpayer's characterization of such payments [to a shareholder-employee] may warrant close scrutiny to ensure that a portion of the purported compensation payments is not a disguised dividend." Therefore, now that we have a case that presented the Tax Court with the opportunity to apportion, I feel that we should follow our existing precedents and the clear mandate of the Treasury Regulations and require that an apportionment take place. [FN5]

> FN5. Even if our precedents did not make clear that an

> apportionment is required whenever purported compensation payments contain disguised dividends, whether because the payments were unreasonable or because the payments were made without the requisite compensatory intent, the Treasury Regulations make clear that an apportionment is required in both cases. See Treas. Reg. 1.162-7(b)(1). These Treasury Regulations are binding upon the Commissioner even in the absence of court precedents. See, e.g., Whiteside v. United States, 833 F.2d 820, 823 (9th Cir.. 1987), and even if there are conflicting court precedents. See Redlark v. Commissioner, 141 F.3d 936, 939-940 (9th Cir.. 1998).

III

The Tax Court Did Not Apportion

A brief review of the Tax Court's opinion makes clear that the court did not apportion the incentive compensation payments between deductible and non-deductible amounts. the court's opinion makes clear that the court rested its decision *1126 solely upon its "conclusion that the plan allocations were not made with compensatory intent and thus did not constitute compensation for services." O.S.C. & Assoc. v. Commissioner, 73 T.C.M. (CCH) 3231. Instead of then determining what amount of compensation would have been reasonable, and allowing the taxpayer a deduction for that amount, the court inexplicably found that "[a]s a result [of not being made with compensatory intent], we sustain respondent's determination for each year". Id.
The Commissioner, asserting that an apportionment was not required, concedes that the Tax Court never apportioned the incentive compensation payments between a deductible portion (equal to a reasonable amount of compensation) and a non-deductible portion (equal to the amount that exceeds the reasonable amount):

> On appeal, the taxpayer argues that the Tax Court erred by failing to address the issue of whether the amounts of compensation paid to Blazick and Richter were reasonable. Taxpayer fails to understand the Tax Court did

> not reach the issue of reasonableness, and indeed did not need to reach that issue, because it disposed of the case on the other prong of the two-prong test: whether the amounts in issue were disguised as dividends rather than compensation for services actually rendered.

Respondent's Brief at 10 (emphasis added), [FN6]

> FN6. At oral argument, the Commissioner contended that an apportionment took place in this case. This apportionment supposedly took place because the Internal Revenue Service agent who prepared the notice of deficiency used the Elliotts factors for determining reasonable compensation to determine a reasonable amount of compensation and disallowed the excessive portion. As discussed below, this apportionment had to be done by the Tax Court in the course of its redetermination of the taxpayer's deficiency. More importantly, however, that agent never testified before the Tax Court. Instead, the Commissioner offered the testimony and report of an expert witness regarding the reasonable amount of compensation. That witness would have allowed more that a million dollars more in compensation to be deducted than was allowed in the notice of deficiency.

The Commissioner further concedes that if it is necessary to determine the amount of reasonable compensation that the taxpayer was entitled to deduct, a necessary first step in an apportionment, a remand to the Tax Court is necessary:

> If this Court should hold that the Tax Court finding that the payments to Blazick and Richter pursuant to the ICP were not for services actually rendered is clearly erroneous, then the second prong of the "reasonable compensation" test must be considered, viz, whether the total compensation paid to Blazick and Richter was reasonable. Because the Tax Court did not reach this issue, a remand may be necessary. [FN7] . . . The Commissioner conceded at trial that Richter's

> compensation was reasonable, but presented persuasive expert testimony that Blazick's compensation was not reasonable to the extent that it exceeded $472,000, $918,000, and $788,000, respectively, for the years 1990, 1991, and 1992.
>
> FN7. The Commissioner makes this rather telling concession because the Commissioner claims that an apportionment is not necessary: "The Tax court did not reach the issue of whether the payments here in issue were reasonable because it had already found that they were not deductible, and therefore there was no clear error in not using the five-factor analysis of reasonable compensation described in Elliotts." Respondent's Brief at 21.

Respondent's Brief at 20 n. 8 (emphasis added).

As previously discussed, the relevant Treasury Regulations require an apportionment. That requires a determination of the reasonable amount of compensation that could have been paid to Blazick and Richter. The remaining question is whether the Commissioner could make that determination, in the determination contained in the notice of deficiency, or whether the Tax Court was obligated to make that determination. In this case, I *1127 believe that the Tax Court was obligated to make that determination.

IV

The Tax Court Had to Apportion

By affirming the Tax Court's decision, which simply sustained the Commissioner's determination that the taxpayer had a deficiency for the tax years in issue, the Majority creates a de facto apportionment because the notice of deficiency only disallowed a portion of the incentive compensation payments. Given the evidence before it, the Tax Court was required to determine for itself what amount of compensation should have been allowed as reasonable.

A brief review of tax procedures is necessary in order to

, understand why the de facto apportionment that results from the Majority Opinion is insufficient in this case. Under the Internal Revenue code, the Commissioner is given the authority to issue a notice of deficiency if he "determines that there is a deficiency." 42 U.S.C. § 6212. The taxpayer, however, may petition the "Tax Court for a redetermination of the deficiency." 42 U.S.C. § 6213. Under Tax Court Rule 142(a), however, the taxpayer bears the burden of proof before the Tax Court. This is because "[t]he Commissioner's deficiency determination and assessments for unpaid taxes are normally entitled to a presumption of correctness so long as they are supported by a minimal factual foundation." Palmer v. United States Internal Revenue Service, 116 F.3d 1309, 1312 (9th Cir.. 1997). "If the taxpayer successfully rebuts the presumption that the assessment is correct, the presumption disappears, and the burden of proving the deficiency reverts to the government." Adamson v. Commissioner, 745 F.2d 541, 547 (9th Cir.. 1984); cf. Demkowicz v. Commissioner, 551 F.2d 929, 931 (3rd Cir.. 1977) (*Once the taxpayer overcomes the presumption [of correctness] by presenting 'competent and relevant credible evidence,' . . . which is sufficient to establish that the Commissioner's determination was erroneous, . . . then the Commissioner has the burden of going forward with the evidence.") (internal citations omitted).

In the three tax years at issue in this case, the taxpayer deducted as compensation the following amounts as compensation for Blazick and Richter: $802,059 for 1990; $2,074,708 for 1991; $1,707,159 for 1992. [FN8] Of these amounts, the Commissioner disallowed the following portion in the statutory notice of deficiency:

FN8. These aggregate amounts were comprised of the following base salary and incentive distrabutions for Blazick and Richter.

	1990	1991	1992
Blazick			
Base salary	$155,372	175,485	173,372
Incentive Distribution	$490,860	1,651,146	1,324,608
Subtotal	$646,232	1,826,631	1,497,980
Richter			
Base salary	$57,791	64,616	60,000
Incentive Distribution	$98,036	183,461	149,179
Subtotal	$155,827	248,779	209,179
TOTAL	$802,059	2,074,708	1,707,159

	1990	1991	1992
Claimed salary	$802,059	2,074,708	1,707,159
Deficiency	$(357,453)	(1,580,631)	(1,198,677)
Allowed Amount	$444,606	494,077	508,482

The taxpayer timely petitioned the Tax Court for a determination of the deficiency. In that proceeding, the taxpayer bore the burden of proof and had to overcome the presumption of correctness afforded the Commissioner's notice of deficiency. In most cases, the taxpayer fails to carry its burden of proof and cannot overcome the presumption of correctness. See, e.g., Nor-Cal Adjusters v. Commissioner, 503 F.2d 359,362 (9th Cir.. 1974) (finding that taxpayer failed to satisfy burden of proof). As the Majority noted, however, this is a "rare" case.

During the trial, the taxpayer introduced the report of an expert witness, Robert H. Rosen, to support its contention that the amounts paid to Blazick and Richter were reasonable. The Tax Court would not allow Rosen to testify regarding the reasonableness of the compensation paid to Blazick and Richter, based on compensation *1128 paid in the commercial printing

industry. I agree with the Majority that this decision was not an abuse of discretion. In addition, the taxpayer introduced the testimony of a competitor, Richard Ayers, to support is contention that O.S.C. was an exceptionally-run printer, largely due to the efforts of Blazick.

Without more, I would have to affirm the Tax Court, because the taxpayer would not have overcome the presumption of correctness associated with the Commissioner's notice of deficiency. But the Commissioner's expert witness, Mae Lon Ding, and the Commissioner's subsequent concession regarding the reasonable amount of compensation that could have been paid to Blazick and Richter, transformed this into the rare case in which the Commissioner's own evidence rebutted the presumption of correctness that attached to the notice of deficiency. Ding supplemented her Compensation Experts Report three times. In the final form, her report would have allowed the taxpayer to deduct a substantially larger amount of compensation than the Commissioner allowed in its notice of deficiency. [FN9]

> FN9. In her final report, Ding would have allowed the following amounts as reasonable compensation:

	1990	1991	1992
CEO	$472,000	$918,000	$788,000
Top Operations Executive	$184,000	$362,000	$306,000

Notwithstanding the Commissioner's own concession that a substantially larger amount of compensation that that allowed in the notice of deficiency would have been reasonable, a concession that followed the dramatic reversal of the Commissioner's expert witness' testimony regarding the proper amount of reasonable compensation, the Tax Court affirmed the Commissioner's deficiency determination as contained in the notice of deficiency. Although the Commissioner's determination in the notice of deficiency is entitled to a presumption of correctness, the notice of deficiency alone is not enough to carry the Commissioner's

ultimate burden of persuasion if sufficient evidence is introduced to overcome the presumption of correctness:

> The notice of deficiency does not result in final liability on the part of the taxpayer. If the taxpayer files a petition in the Tax court, liability will be adjudicated prior to payment. 26 U.S.C. § 6213. The notice of deficiency merely hails the taxpayer into court. The Tax Court has as its purpose the redetermination of deficiencies, through a trial on the merits, following a taxpayer petition. it exercises de novo review. See, e.g., Raheja v. Commissioner, 725 F.2d 64, 66 (7th Cir.. 1984). Issuing a notice of deficiency is in many ways analogous to filing a civil complaint. Clapp v. Commissioner, 875 F.2d 1396, 1403 (9th Cir..1989). [FN10]
>
> FN10. In this case, the Internal Revenue Service agent who prepared the notice of deficiency did not testify. As a result, the notice of deficiency itself, without testimonial evidence to explain the basis for its determination of a deficiency, is all that the Tax Court could rely upon in affirming the Commissioner's determination, unless it relied upon the testimony of Ding or Ayers. We would be faced with a decidedly different case if the Commissioner had called the Internal Revenue Service agent, who was on the Commissioner's witness list, to explain the basis of the determination of the deficiency contained in the notice of deficiency.

The question then becomes whether sufficient evidence was introduced to overcome the presumption of correctness that attaches to the notice of deficiency. Although this circuit has not yet articulated the precise quantum of evidence necessary to overcome the presumption of correctness, [FN11] I am confident that the taxpayer *1129 met its burden when '[t]he Commissioner conceded at trial that Richter's compensation was reasonable, but presented persuasive expert testimony that Blazick's compensation was not reasonable to the extent that it exceeded $472,000,

$918,000 and $788,000, respectively, for the years 1990,1991, and 1992." Respondent's Brief at 20, n. 8, a concession that would have allowed the taxpayer to deduct $1,343,918 more than allowed in the notice of deficiency. [FN12]

> FN11. Our circuit has not defined what quantum of evidence is necessary to overcome the presumption of correctness and shift the burden of production to the Commissioner because our circuit has place the ultimate burden of persuasion upon the taxpayer rather than the Commissioner. compare Getty v. Commissioner, 913 F.2d 1486, 1492 (9th Cir.. 1990) ("When contesting a deficiency determination by the Commissioner, the burden of persuasion rests on the taxpayer.") with Cebollero v. Commissioner, 967 F.2d 986, 991 9th Cir.. 1992) (indicating that "the Commissioner always has the burden of persuasion as to the amount and existence of any deficiency"). As a result, we traditionally have resolved cases by concentrating upon the preponderance of evidence standard that governs the taxpayer's burden of persuasion, rather than addressing what quantum of evidence is necessary to overcome the presumption of correctness. See, e.g., Rockwell v. Commissioner, 512 F.2d 882, 885 (9th Cir.. 1975) (indicating that "[t]he presumption in favor of the Commissioner is a procedural device which requires the taxpayer to come forward with enough evidence to support a finding contrary to the Commissioner's determination, " and that "[t]he burden of proof is another matter.") Given that the only evidence in this case, the reports of the Commissioner's compensation expert witness, as well as a concession by the Commissioner that indicated that more than a million dollars of compensation than allowed in the notice of deficiency would have been reasonable compensation, the taxpayer clearly carried its ultimate burden of persuasion.
>
> FN12. In its brief before the Tax Court, the Commissioner

> conceded that "Ms. Ding's final report contains maximum reasonable compensation amounts for Richter that are greater than is actual compensation. Therefore, respondent concedes that Richter's compensation was reasonable in amount." Respondent's Brief before the Tax Court at 22. The Commissioner, recognizing the difficulty of this concession, claimed that "[b]ecause the incentive compensation payments to Richter were disguised dividends, such payments are not deductible even though reasonable in amount." Id. n. 5.

Therefore, the Tax Court was required to determine de novo whether the taxpayer had a deficiency for the years in question. The court should have determined for itself, based upon the evidence (rather than merely the notice of deficiency), the reasonable amount of compensation that the taxpayer could deduct. Inexplicably, it chose not to, affirming the notice of deficiency and disallowing a $1,343,918 deduction that the Commissioner's witness conceded was reasonable compensation.

Because the Majority affirms the Tax Court, relying upon a de facto apportionment rather than the apportionment that the taxpayer was entitled to, I respectfully dissent.

FILED
NOV - 2 1999
CATHY A. CATTERSON, CLERK
U.S. COURT OF APPEALS

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

O.S.C & Associates,
Plaintiff-Appellant,

v.

Commissioner of Internal Revenue,

Defendant-Appellee.

No. 97-71199

Tax Court

ORDER

Before: WIGGINS, TASHIMA and SILVERMAN, Circuit Judges.

Judges Tashima and Silverman have voted to deny appellant's petition for rehearing and to reject the suggestion for rehearing en banc. Judge Wiggins has voted to grant the appellant's petition for rehearing and recommends acceptance of appellant's suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc. and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App.P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

SECTION 1.162-7.

COMPENSATION FOR PERSONAL SERVICES.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is *not decisive as to deductibility.* While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder

SECTION 1.162-8.
TREATMENT OF EXCESSIVE COMPENSATION.

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.